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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,

Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF OF BRUCE A. MARKELL AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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BRIEF OF BRUCE A. MARKELL AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF *AMICUS CURIAE*[*]

In accordance with Rule 37.3(a) of this Court's rules, the undersigned respectfully submits his pro se *amicus curiae* brief in support of Respondent. Both parties have consented to the filing of this brief, and their written consents are on file with the Clerk of the Court.

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[*] In accordance with Supreme Court Rule 37.6, the undersigned *amicus curiae* represents that no party other than himself authored this brief, or any part of it, and that no other person or entity has made a monetary contribution to any aspect of this brief's preparation or submission, including its printing.

Amicus is a law professor and student of bankruptcy law. He has written articles on the issue presented in this case, and is the principal author of chapters 1111 and 1129 in COLLIER ON BANKRUPTCY (15th rev. ed. 1998). He represents no institution, group or association, and as with those academic *amici* supporting Petitioner, submits this brief to offer what assistance he can on this critical issue in bankruptcy reorganization practice.

SUMMARY OF ARGUMENT

1. Section 1129(b)(1) of the Bankruptcy Code[1] governs this case. It allows courts, under specified conditions, to confirm plans of reorganization in bankruptcy which have the support of some, but not all, of the debtor's creditors. One of these conditions is that such a plan must be "fair and equitable" as to any dissenting class of creditors. The Bankruptcy Code does not, however, define the exact scope of "fair and equitable." Rather, Congress provided, in Section 1129(b)(2), non-exclusive examples of compliance with the "fair and equitable" rule. Section 1129(b)(2)(B)(ii), the example at issue in this case, states that a plan is not "fair and equitable" when the holder of a junior interest receives or retains anything under the plan "on account of" that holder's pre-bankruptcy interest.

To ensure a reading of Section 1129(b)(2)(B)(ii) that does not render the phrase "on account of" superfluous, courts must be able to confirm plans of reorganization over the dissent of a class when junior interests receive some interest under a plan of reorganization. Otherwise, Congress could have dropped the words "on account of," with the result that Section 1129(b)(2)(B)(ii) would bar equity holders and other

[1] In this brief, all reference to the "Bankruptcy Code" or simply the "Code" are references to title 11 of the United States Code which codifies federal bankruptcy law. Similarly, references to "Section xxxx" are references to that section in title 11 of the United States Code.

junior interests from ever receiving any interest under a plan of reorganization.

The circumstances under which equity holders can continue their ownership in a bankruptcy debtor -- that is, the circumstances when receiving an interest are *not* "on account of" their prior interest -- are provided by the history and purpose of the "fair and equitable" requirement. That such history is relevant is shown by Congress' decision to incorporate, in Section 1129(b)(1), a term of art such as "fair and equitable." When Congress chooses to use a term of art in a technical statute such as the Bankruptcy Code, this Court has looked to the statutory context of the wording, and has deferred to prior judicial interpretations of that term.

2. The phrase "fair and equitable" is one of the most history-laden phrases in the Bankruptcy Code. Congress first used the phrase during the Depression to incorporate, into statutory bankruptcy law, judicial concepts originating in federal equity receiverships. These receivership practices developed during the later part of the Nineteenth Century in response to the need to reorganize, rather than liquidate, large capital-intensive business such as railroads. One of the many practices incorporated into the "fair and equitable" concept was the ability of the shareholders in an insolvent debtor to make fresh contributions of capital in return for an interest in the reorganized entity roughly worth the amount of the contribution. Indeed, the cases involving owner contributions focused not on *whether* equity owners could participate in reorganizations; rather, they focused *on what terms* such owners could participate. This Court has always indicated that such practices are part of the "fair and equitable" concept, and there is no reason to reject those cases here.

3. Finally, that this reading of Section 1129(b)(1) is correct is confirmed by the logic and policy of corporate reorganizations generally. As a matter of logic, the formulations of standards for the application of the "fair and equitable" rule can be mathmatically reformulated to show that owner participation, on the same terms as participation by

independent third parties, is a logical and integral part of "fair and equitable." As to policy, the Bankruptcy Code seeks to preserve viable businesses for all stakeholders, be they creditors, owners or the communities in which the businesses are located. Allowing equity holders to participate in the reorganization process on the same basis as other potential buyers of the debtor furthers this goal by increasing the pool of those interested in buying the post-confirmation debtor. This increased pool, in turn, leads to higher bids or contributions to the debtor, with concomitant higher returns to all stakeholders.

ARGUMENT

I. Section 1129(b)(1)'s Requirement That a Non-Consensual Plans Be "Fair and Equitable" Governs This Case

Chapter 11 of the Bankruptcy Code expressly permits confirmation of chapter 11 plans of reorganization[2] without the unanimous consent of all classes of creditors. In Section 1129(b)(1) of the Code, Congress provided express conditions for confirmation: all requirements for a consensual plan set for in Section 1129(a) (except for consent) must be met and, in addition, the plan must be "fair and equitable, with respect to each" dissenting class. 11 U.S.C. § 1129(b)(1).

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[2] A chapter 11 plan of reorganization is a document prepared by the parties which specifies both the method and manner of satisfaction of creditor claims and the proposed structure of the debtor after reorganization. Individuals, called "plan proponents," may propose such plan, which are summarized and distributed to creditors and equity holders. If all other requirements are met -- including a requirement that the reorganization will not likely be followed by the need for further reorganization, 11 U.S.C. § 1129(a)(11) -- then the bankruptcy judge "confirms" the plan by entering an order giving the plan effect. The confirmation order affects all creditors and equity security holders of the debtor, regardless of how they voted on the plan, 11 U.S.C. § 1141(d). A confirmed plan has the effect of a grand novation of all of the debtor's obligations. *See generally* COLLIER ON BANKRUPTCY ¶ 1129.01[1] (15th rev. ed. 1998).

In this case Respondent, 203 North LaSalle Street Limited Partnership ("Debtor"), confirmed a plan of reorganization in its chapter 11 bankruptcy case without the consent of Petitioner, Bank of America, NT&SA ("Bank"). Debtor, as the plan proponent, bore the burden of establishing that its plan met all of Section 1129(a)'s requirements, other than voting, and was "fair and equitable" as to the Bank. The bankruptcy court found that the Debtor had met this burden, and the district court and the Seventh Circuit panel affirmed. In this Court, the Bank claims that the plan was not "fair and equitable" as to its unsecured deficiency claim, a claim that is non-existent under state law, and exists only in chapter 11 as a matter of federal law.[3]

Whether a plan is "fair and equitable," however, is a question with long historical antecedents. To reflect and simplify the application of that history, Congress added Section 1129(b)(2) which gives a non-exclusive list of examples of "fair and equitable" treatment. The dissent below, and the Bank and the *amici* here, focus primarily on a clause contained in a sub-paragraph of Section 1129(b)(2) in concluding that the Debtor's plan could not be confirmed.

That argument is wrong as a matter of statutory construction. As Debtor's brief in this Court shows, the language of Section 1129(b)(2)(B)(ii) does not bear the weight of construction placed on it by the Bank. It either

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[3] Under the Bankruptcy Code, the Bank has two claims: a secured claim equal to the value of its collateral, and an unsecured claim equal to the deficiency between the total obligation owed and the value of the collateral. 11 U.S.C. § 506(a). The plan here fully satisfied the secured claim, leaving only the unsecured deficiency claim. The Bank, however, made its loan on a non-recourse basis; that is, it agreed not to look to the debtor for any remaining claim owed after the Bank foreclosed its mortgage. Although such arrangements are respected in chapter 7 liquidations, in chapter 11 reorganizations the Code gives non-recourse lenders such as the Bank enhanced protection by recognizing, notwithstanding contrary non-bankruptcy law, the claim which would remain after foreclosure. 11 U.S.C. § 1111(b)(1)(A). *See generally* COLLIER ON BANKRUPTCY, *supra*, at ¶ 1111.03.

misconstrues the type of causation anticipated by Section 1129(b)(2)(B)(ii)'s "on account of" language, or it reads that language out of the statute altogether.

It is no accident that Congress included the "on account of" language in Section 1129(b)(2)(B)(ii). Its placement there serves to amplify that no equity holder can, without more, retain its interest in the debtor if any dissenting class of creditors is unpaid. But if the equity holder does more -- if in the terms of the statute its receipt of an interest in the post-confirmation debtor is *not* "on account of" its pre-petition interest -- then Section 1129(b)(2)(B)(ii) does not apply. The question then becomes whether the general rule, found in Section 1129(b)(1), permits equity holders to make contributions and receive interests tailored to the consideration paid for those interests. Put another way, the issue is whether Section 1129(b)(1)'s requirement that a plan be "fair and equitable" as to dissenting classes prohibits such a plan.

It is manifest that a simple reading of the simple phrase "fair and equitable" does not answer this question. It was not intended to. The term "fair and equitable" is a term of art rich in history and meaning, and has been so for over 50 years. SECURITIES AND EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, *Part VIII* (A Summary of the Law Pertaining to Equity and Bankruptcy Reorganizations and of the Commission's Conclusions and Recommendations), at 142 (1940) [hereinafter cited as "SEC REPORT"].

When Congress uses terms of art such as "fair and equitable" in a statute, as this Court recently stated, "it is a 'fundamental principle of statutory construction (and, indeed, of language itself) that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used.'" *Textron Lycoming Reciprocating Engine Division v. United Automobile, Aerospace & Agricultural Implement Workers*, 118 S. Ct. 1626, 1629 (1998), *quoting Deal v. United States*, 508 U.S. 129, 132

(1993). As Chief Judge Posner has recently added when interpreting the Bankruptcy Code, "[t]he context consists not merely of other sentences but also of the real-world situation to which the language pertains. . . . When context is disregarded, silliness results." In re *Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125, 1128 (7th Cir.1998).

The "real-world situation" applicable in this case is the confirmation of a plan of reorganization, and over a hundred years of jurisprudence as to what is fair and equitable. In such cases this Court has recognized that "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications." *Midlantic Nat'l Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 501 (1986) (citation omitted). *See also Dewsnup v. Timm*, 502 U.S. 410, 419-20 (1992). That the wording Congress chose in Section 1129(b)(1) simply carried over pre-Code practice -- a practice that included new value principles -- is shown by the phrase's history and use in corporate reorganizations.

II. Through the Use of the Words "Fair and Equitable," Congress Captured a Concept With a Well-Known Meaning in Reorganization Practice

Congress did not pick the words "fair and equitable" out of thin air when it adopted Section 1129(b)(1) in 1978. Rather, Congress borrowed the phrase from prior bankruptcy enactments, which in turn were attempts to codify then-existing judicial practice. In short, when Congress chose the term "fair and equitable" as the test for non-consensual plans of reorganization, it was writing against over forty years of statutory history and over a century of reorganization practice.

A. *The Judicial and Statutory Origins of "Fair and Equitable"*

In large part, the history of corporate reorganizations is the history of railroad reorganization. Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74-83 (1991) [hereinafter cited as "*Owners, Auctions*"]. Prior to 1933, however, railroad reorganizations were handled in federal equity receiverships; railroads were not eligible to be bankrupts under the Bankruptcy Act of 1898. Such receiverships were often necessary. By 1915 over one-half of all railroad debt securities had been in default at one time or another. WILLIAM Z. RIPLEY, RAILROADS: FINANCE & ORGANIZATION 374 (1915).[4]

The funds used to reorganize these companies typically came from existing shareholders. Necessity dictated this trend. Equity holders were thought to be the most likely source. *See* 2 ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 1327-33 (4th ed. 1941). Indeed, this Court and others had many occasions to pass on the propriety of continued owner participation in equity receiverships. *See, e.g., Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913); *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*, 174 U.S. 674 (1899); *Chicago Rock Island & Pac. R.R. v. Howard*, 74 U.S. (7 Wall.) 392 (1868); *Jameson v. Guaranty Trust Co.*, 20 F.2d 808 (7th Cir. 1927); and *Oehring v. Fox Typewriter Co.*, 272 F. 833 (6th Cir. 1921).

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[4] Writers during this time seemed to embrace a fairly constant estimate that, at any given time, about one in seven railroads were in receivership. *See, e.g.*, Paul D. Cravath, *Reorganization of Corporations*, in 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153, 154 (1917); John Franklin Crowell, *Railway Receiverships in the United States*, 7 YALE REV. 319, 319 (1898).

1. The First Codification -- Sections 77 and 77B

All of this changed during the Depression. In 1933, Congress added Section 77 to the 1898 Bankruptcy Act. Act of March 3, 1933, ch. 204, 47 Stat. 1467. Not only did this section change prior law by permitting railroads to be bankrupts, it also codified and incorporated existing receivership practices.

One such practice was the drafting and approval of plans of reorganization which stated the revised capital structure of the reorganized entity, and which also provided for distributions to creditors. *Owners, Auctions*, *supra* at 74-77. To confirm a plan, Section 77 followed equity practice and required that the plan be "fair." Act of March 3, 1933, ch. 204, § 77(g), 47 Stat. 1467, 1479. *See* SEC REPORT, *supra* at 142 ("Since these words [fair and equitable] were not defined in the statutes, it was to be expected that their meaning would be derived from the background of equity reorganization practice.").

A year later, when extending bankruptcy relief to municipalities, Congress used, for the first time, the full phrase "fair and equitable." Using Section 77 as a template for municipal reorganization, Congress added the words "and equitable" to "fair" in the provisions related to confirmation of plans. Act of May 24, 1934, ch. 345, § 80(e), 48 Stat. 798. Shortly thereafter, Congress again used this revised language of "fair and equitable" when enacting Section 77B, which extended bankruptcy reorganization relief to corporations generally. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912.[5]

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[5] Until the Depression, reorganization relief was not generally available under statutory bankruptcy law. A business could liquidate under chapter VII of the 1898 Bankruptcy Act, or try to effect a composition with its unsecured creditors under that Act. Although helpful in some situations, these provisions proved inadequate to allow broad-based reorganizations of large and small companies. Federal equity practice came to provide these types of powers, and thus the majority of

Section 77B's confirmation requirements thus mirrored the municipal reorganization act: it required that, to be confirmed, plans had to be "fair and equitable." *Id.* § 77B(f)(1). A year later, in 1935, Congress amended the railroad reorganization provision -- Section 77 -- to conform to this formulation. Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918.

2. The Meaning of the First Codification: *Case v. Los Angeles Lumber Prods. Co.*

Against this background, this Court heard *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939). In *Case*, the debtor had filed under new Section 77B of the 1898 Bankruptcy Act. Using Section 77B's provision which allowed the debtor to retain possession of its assets, the debtor continued to operate and propose a plan. Under this plan, existing shareholders retained 23% of the equity for no additional monetary consideration. Bondholders, such as the petitioner Thomas Case, were to receive the remainder, plus certain preferred shares.

The question presented was whether the plan was "fair and equitable" within the meaning of Section 77B(f)(1). This Court, speaking through Justice William O. Douglas, stated the "words 'fair and equitable' . . . are words of art which prior to the advent of § 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations." 308 U.S. at 115. In essence, Justice Douglas used the congressional phrase "fair and equitable" as a lens through which to view and carry forward the practices and precedents of equity receiverships. He confirmed this reading by citing pre-1933 precedents of this Court and other lower courts as determinative of the content of the phrase "fair and equitable." *Id.* at 116-120 (*quoting*

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what we would call "reorganizations" today were carried out in federal equity courts before the 1930s. The history of receivership practice is recounted in *Owners, Auctions, supra* at 74-83.

Chicago Rock Island & Pac. R.R. v. Howard, 74 U.S. (7 Wall.) 392 (1868); *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*, 174 U.S. 674 (1899); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913); and *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926)).

Chief among the components of "fair and equitable" that Justice Douglas examined was the so-called absolute priority rule. At issue in *Case* was the view that the term "fair and equitable" permitted plans that preserved "relative priority;" that is, that preserved claims to future income based on current entitlements without the necessity of first paying senior claims in full. The proposed stock issuance, together with certain dividend restrictions on the stock issued, preserved relative priorities.[6] *Case*, 308 U.S. at 119-20. Under the absolute priority standard, the plan failed miserably. The debtor's principal assets were worth some $830,000, and there was a first mortgage outstanding of more than $3,800,000. *Id.*

Thus, *Case* could have been decided solely on absolute priority grounds. The value of the debtor's property did not permit continued participation by its shareholders. Although the debtor's main arguments concerned the relative priority standard, it also attempted to show that even absolute priority would permit continued shareholder participation. It argued that its shareholders were contributing sufficient value to retain their interests through their "continuity of management" and "financial standing and influence in the community." *Id.* at 122.

Justice Douglas did not dismiss this argument out of hand, as would Bank in this case. Instead, Justice Douglas recognized that old equity owners could participate, but only

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[6] Under relative priority, the value of the securities issued to such shareholders often *exceeded* the amount contributed by the shareholders. *See* A.S. DEWING, *supra*, at 1395; Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 914-15 (1927).

under certain conditions. In this respect, he was following this Court's precedent. In particular, this Court had stated in *Kansas City Terminal Ry. Co. v. Central Union Trust Co. of New York*, 271 U.S. 445, 455 (1926), that "[g]enerally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them."

In *Case*, Justice Douglas gave content to this notion. In particular, he stated that "where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." *Case*, 308 U.S. at 122.

Justice Douglas then applied only half of this test. He first looked at the proposed contributions of continuity and reputation. These were surely different from the cash asSess.ments prevalent in equity reorganizations. He categorized the claimed contributions as "intangible[]" and "ephemeral." *Id.* at 122-23. Allowing such "vague hopes or possibilities" to count as contributions, he stated, would permit "easy evasions of the principle of full or absolute priority . . .. ." *Id.* at 122.

Having disqualified the proffered consideration's quality, Justice Douglas never analyzed its quantity. As a consequence, he never directly addressed the scope and meaning of "reasonable equivalen[ce]". Had Section 77B stayed in the Act, shareholders may have had the incentive to test the limits of "reasonable equivalen[ce]."

3. The Second Codification -- The Chandler Act of 1938

As Justice Douglas knew, one year prior to *Case*, Congress had overhauled the corporate reorganization sections of the Bankruptcy Act. The Chandler Act, Act of June 22, 1938, ch. 575, 52 Stat. 840, repealed the single reorganization section, § 77B, and inserted three new chapters

in its place. Congress intended the first, Chapter X, to do the bulk of the work of reorganizing large, public companies. The second chapter, Chapter XI, continued and formalized the Bankruptcy Act's composition provisions, which were directed primarily at small, owner-managed concerns. The third chapter, Chapter XII, dealt primarily with real estate partnerships.

Each of these revisions required plans of reorganization, and each copied the wording of Sections 77, 77B and the municipal arrangement section in that each required that "the plan [be] fair and equitable . . . ." to be confirmed. *See* 11 U.S.C. § 621(2) (repealed 1979) (Chapter X standard for confirmation). In explaining this provision, the legislative history simply said: "Subsection (2) of Section 221 [codified at 11 U.S.C. § 621(2)], derived from Section 77B(f)(1), provides, as a condition to confirmation of a plan, that the judge be satisfied that it is "fair and equitable," and "feasible." S. REP. NO. 1916, 75th Cong., 3d Sess. 35-36 (1938) (Senate Report No. 1916 accompanied H.R. 8046, which was the bill ultimately enacted). *See also Analysis of H.R. 12889*, 74th Cong., 2d Sess. 78 n.2 (Comm. Print 1936).

4. The Preservation of New Value Principles After *Case*

This Court, in a series of cases in the early 1940's, quickly confirmed that *Case*'s reading of "fair and equitable" applied to the same phrase in Section 77, *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R.*, 318 U.S. 523, 542 (1943), and in Chapter X, *Marine Harbor Prop., Inc. v. Manufacturer's Trust Co.*, 317 U.S. 78, 85 (1942).[7] It also held that Congress' decision to

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[7] During this period, the Court also elaborated on new value components in the unfair discrimination standard then located in the municipal arrangement statute. *Mason v. Paradise Irrigation Dist.*, 326 U.S. 536 (1946). *See* Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227 (1998).

separate reorganization relief into three classes was to be respected. The simpler Chapter XI procedure could not be used when Chapter X was more appropriate. *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434 (1940); *see also General Stores Corp. v. Shlensky*, 350 U.S. 462 (1956).

These decisions drastically affected reorganization practice. *See* Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1, 9-15 (1995). No longer could parties use the less formal Chapter XI procedure in large cases, or when more than simple adjustment of unsecured claims was required. In Chapter X, unlike Chapter XI, the debtor would be immediately replaced by a trustee. *Id.* at 11-12. The debtor would also lose exclusivity to file a plan; in Chapter X the trustee controlled the plan process. *Id.* Finally, it also meant that the minimum percentage of creditor acceptances would have to be higher; Chapter X required consents from two-thirds of an affected class while Chapter XI only required a simple majority. *Id.*

One main consequence flowed from these cases: the opportunities for new value cases dried up. Most of the cases which could have been candidates for new value principles had the debtor still been in control were now plans sponsored by the Chapter X trustee. In these plans, the equity owners and management were treated the same as any third party who wished to bid for the company in reorganization. *See, e.g.*, In re *Polycast Corp.*, 289 F. Supp. 707 (D. Conn. 1968) (trustee contacted over forty companies to find acquisition partner before sponsoring plan with debtor's management group).

Against this background, courts never received a chance in Chapter X cases to apply the second half of Justice Douglas' formulation of new value principles. Cases under Chapter XI and XII provided no precedent since Congress had eliminated the "fair and equitable" rule from those cases in 1952. *See* Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433.

The precedents for owner participation recognized by Justice Douglas in *Case*, seemingly moribund under Chapter X, gained new life when the 1978 Code resurrected Section 77B's concept of the debtor in posSess.ion, 11 U.S.C. § 1101, and when Congress, in Section 1121 of the Code, carried over a limited version of Chapter XI's concept of debtor exclusivity as to plan proposal.

5. The Third Codification -- The Bankruptcy Reform Act of 1978

The 1978 law, at issue in this case, got its first real start in 1973 when the congressional-authorized Bankruptcy Commission made its report. *Bankruptcy Comm'n of the United States of America, Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. 93-137, 93d Cong., 1st Sess., Parts I-II (1973) [hereinafter cited as "*Commission Report.*"]. This report comprehensively addressed the perceived shortcomings of the 1898 Bankruptcy Act, and proposed various reforms.

Among other things, the report found fault with the absolute priority rule. But the fault found was *not* that the rule was too loose. To the contrary, the Commission found "the rigidity of the [absolute priority] rule has frequently resulted in the destruction rather than the protection of interests of public investors. . . . [These investors] are frequently eliminated from participation in a reorganization by reason of the strict application of a statute designed primarily for their protection." *Commission Report*, Part I, at 256. In response, the report suggested a relaxation of some of the harder edges of the absolute priority rule. Under the proposal, equity owners could participate "if their future contributions, e.g., continued management, [were] essential to the business." *Id.*, Part II, § 7-303(4), at 258.[8]

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[8] Section 7-303(4) was designed to "adopt[] the District Court's opinion which was reversed in *Case* . . . ." *Id.*, Part II, at 254 (Com. 9(b)).

The Commission also suggested allowing delayed participation, under which equity holders could participate only if future increased performance justified that participation. *Id.*, Part II, § 7-303(3), at 241. Finally, it sought to streamline the type and amount of valuation evidence necessary to establish compliance with the absolute priority rule. *Id.*, Part II, § 7-310(2)(B), at 252. The Commission's bill was introduced during the later days of the Seventy-third Congress, H.R. 10792, 93d Cong., 2d Sess. (1973); S. 2565, 93d Cong., 2d Sess. (1973), and reintroduced at the beginning of the Seventy-fourth, H.R. 31, 94th Cong., 1st Sess. (1975); S. 236, 94th Cong., 1st Sess. (1975).

The Commission's proposed relaxation of absolute priority contained in these bills drew immediate and harsh criticism.[9] Partly as a result of disagreement over this point, an alternative bill was proposed sponsored primarily by bankruptcy judges, H.R. 32, 94th Cong., 1st Sess. (1975); S. 235, 94th Cong., 1st Sess. (1975). Faced with two contrary bills, each supported by factions whose support was necessary to enact, the legislative process halted.

This deadlock broke in early 1976 through compromise. The compromise called for two changes to the absolute priority rule, neither of which addressed the existing ability of owners to contribute fresh capital. Under the first change, only a *class* of creditors could invoke the "fair and equitable" rule. In this respect, the compromise overruled *Case* procedurally; if outvoted, no *individual* creditor could challenge a plan on the grounds that it was not "fair and

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[9] *Hearings Before the Subcommittee on Improvements in Judicial Machinery of the Committee on the Judiciary, United States Senate, on S. 235 and S. 236*, Parts 1 and 2, 94th Cong., 1st Sess 459 (1975)(Statement of Robert J. Grimmig on Behalf of the American Bankers Association); *id.* at 654-55 (Statement of the American Life Insurance Association, represented by John J. Creedon); *id.* at 709-10, 716 (statement of Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission)("We oppose the . . . modifications of the absolute priority rule.")

equitable"; that right would now accrue only to dissenting *classes* of claims.

Second, in lieu of the absolute priority rule, individual creditors received the best interest of creditors test, now found in Section 1129(a)(7) of the Code. As a consequence, once a creditor received property under a plan equal in value to what it would receive in a chapter 7 liquidation, the Code would then allocate the surplus of going concern value over liquidation value by democratic vote within and among classes of creditors. J. Ronald Trost, *Corporate Bankruptcy Reorganization: For The Benefit of Creditors or Shareholders?*, 21 U.C.L.A. L. REV. 540, 550-51 (1973).

The terms of this compromise were then set out in a letter to Congress from the respective heads of the National Bankruptcy Conference and of the National Conference of Bankruptcy Judges. The letter is reprinted in the legislative history. June 12, 1976 Letter from John Copenhaver, President, National Conference of Bankruptcy Judges and Charles A. Horsky, Chairman, National Bankruptcy Conference, *reprinted in Hearings Before the Subcommittee on Civil and Constitutional Rights of the Committee on the Judiciary, House of Representatives on H.R. 31 and H.R. 32, Bankruptcy Act Revision*, Part 3, 94th Cong., 1st & 2d Sess. 1938 (1976).

That letter explained that the compromise obviated the need to debate the Commission's proposed relaxation of the rule: "[b]ecause of the changes in the confirmation rules, the provisions of the pending bills which 'relax' the absolute priority rule standards, i.e., § 7-303(3) and (4) (delayed participation and key man contribution) are no longer necessary." *Id.* at 1941. This letter of compromise, together with the Commission's work, thus formed the basis for the Code's sections involving the absolute priority rule. *Subcommitee [sic] on Civil and Constitutional Rights of the Committee on the Judiciary, Table of Derivation of H.R. 8200*, 95th Cong., 1st Sess. 23 (Comm. Print 1977).

This compromise did not address new value issues; they had simply not been part of the debate. The natural conclusion from this silence is that the compromise fairly stated all contemplated changes. Other components of the "fair and equitable" rule -- such as the prohibition on being paid more than the allowed amount of a claim and new value principles -- remained unaffected. In short, rejection of the Commission's "relaxation" proposal did not affect other components such as new value. This conclusion is borne out by the legislative changes and statements following the compromise, none of which even suggest that changes to new value principles were intended or effected.

The first bill introduced after the compromise, H.R. 6,[10] contained nothing which affected new value. It simply contained a short statement that a court would confirm a non-consensual plan "if such plan is fair and equitable with respect to all classes except any class that has accepted the plan . . . ." *Id.*

This bill was amended two and one-half months later, again without explicit mention of new value principles. This amendment scrapped the simple injunction that the plan be "fair and equitable." In its stead it substituted a lengthy attempt to define the boundaries of fair and equitable treatment. *See* H.R. 6, 95th Cong., 1st Sess., § 1129(b), at 192-93 (Mar. 21, 1977). Successive bills added to and refined

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[10] As initially introduced on January 4, 1977, Section 1129(b) of H.R. 6 read as follows:

> (b) If all of the requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of such plan, shall confirm such plan notwithstanding such paragraph if such plan is fair and equitable with respect to all classes except any class that has accepted the plan and that is comprised of claims or interests on account of which the holders of such claims or interests will receive or retain under the plan not more than would be so received or retained under a plan that is fair and equitable with respect to all classes.

H.R. 6, 95th Cong., 1st Sess § 1129(b), at 175 (Jan. 4, 1977).

the statement of the rule. *See* H.R. 7330, 95th Cong., 1st Sess. § 1129(b), at 201-02 (May 23, 1977); H.R. 8200, 95th Cong., 1st Sess. §1129(b), at 203-05 (July 11, 1977); and H.R. 8200, 95th Cong., 1st Sess. §1129(b), at 205-07 (Sept. 8, 1977). Ultimately, the House Report reflected these changes, but categorized them as a "partial codification" of the absolute priority rule. H. REP. NO. 595, 95th Cong., 1st Sess. 414 (1977). *See* Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 240-44 (1990) (Professor Klee was a member of the House staff which worked on H.R. 8200)

After some haggling with the Senate,[11] a revised House Bill -- still numbered H.R. 8200 -- prevailed. Rather than prepare a formal conference report, the floor managers of the House and Senate chose to have virtually identical "legislative history" read into the congressional record to record the changes made in conference.[12]

The revised bill changed non-consensual confirmation considerably. H.R. 8200, as reported in House Report No. 595, had one subsection on cramdown, and did *not* use the words "fair and equitable." H.R. 8200, 95th Cong., 1st Sess. § 1129(b), at 205-07 (Sept. 8, 1977). The bill after conference split the subsection on cramdown into two paragraphs, and

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[11] The Senate attempted to substitute a bill sponsored by the Securities and Exchange Commission in place of the House version. S. 2266, 95th Cong., 2d Sess (1978). This bill attempted to preserve a two-track reorganization system, and a mandatory trustee for public companies which filed for bankruptcy protection. *Id.* § 1130. Further, non-public companies were not subject to the fair and equitable rule; public companies were. *Id.*

[12] As noted at the time, Congress believed that this procedure imbued such remarks with "the effect of being a conference report." 124 CONG. REC. 32,376 (1978)(statement of Rep. Rousselot). As this Court has subsequently noted: "Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent." *Begier v. IRS*, 496 U.S. 53, 64 n.5 (1990).

explicitly reintroduced the phrase "fair and equitable." H.R. 8200, 95th Cong., 2d Sess. § 1129(b), *reprinted in* 124 CONG. REC. 32,350 (1978).

The first paragraph of the revised bill -- now found in Section 1129(b)(1) -- harkened back to H.R. 6 by providing that a court could cram down a plan over a dissenting class only if the plan was, among other things, "fair and equitable." Although the bill did not attempt to explicitly define this concept, Congress' efforts to define it during the early part of 1977 were not lost. These efforts were added as a second paragraph -- now found in Section 1129(b)(2) -- which contained the various non-exclusive examples developed in earlier bills.

In short, the new bill fused Congress' prior efforts, keeping the early effort started in H.R. 6 as the general rule, and using the later effort, found in the early versions of H.R. 8200, as specific examples of the general rule. As the floor remarks made clear, courts were not to exclude other components and interpretations.[13]

This history shows that in 1978 Congress sought, through retention of the phrase "fair and equitable," to retainn both the wording and the learning of past reorganization practice. As before with the 1938 amendments, the exact contours of a "fair and equitable" plan were left in the care and development of the judiciary. Also as before, as shown by the lack of any direct attack on *Case*, new value principles continued undiminished as part of the history and the content of the phrase "fair and equitable."

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[13] *Id.* at 32,407 (statement of Rep. Edwards); *id.* at 34,006 (statement of Sen. DeConcini) ("Although many of the factors interpreting 'fair and equitable' are specified in paragraph (2), others, which were explicated in the description of section 1129(b) in the House report, were omitted from the House amendment to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable' treatment of a dissenting class.").

B. *Congress' Use of "Fair and Equitable" Incorporated Into Section 1129(b)(1) a Dynamic Rule That Covers Far More Than Section 1129(b)(2)'s Examples*

That Section 1129(b)(1) is not limited by Section 1129(b)(2)'s examples is shown by the introductory material of Section 1129(b)(2). It introduces the various examples with the word "includes," which under the Code is expressly non-inclusive. 11 U.S.C. § 102(3) ("'includes' and 'including' are not limiting").

It can also be seen from the floor statements indicating that what was accomplished was only a partial codification, *see* note 13 *supra*, from what remains uncodified, and from recent developments in application of the concept.

1. The Uncodified Components

The scope of the unmentioned and non-excluded items was broad and basic. It is demonstrative of the scope of reliance on past practice that *neither* Section 1129(b)(1) *or* Section 1129(b)(2) even *uses* the words "absolute priority." The drafters just assumed that courts would continue to apply that principle even if it were not named.

Other essential concepts failed to receive explicit statutory expansion. Chief among these was the basic rule that no participant should receive more than its nonbankruptcy entitlement. *New England Coal & Coke Co. v. Rutland R. Co.*, 143 F.2d 179, 186 (2d Cir. 1944); In re *Evans Prod. Co.*, 65 B.R. 870, 873 (S.D. Fla. 1986); COLLIER ON BANKRUPTCY, *supra*, ¶ 1129.04[4][a][ii]. *See also* 124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards); *id.* at 34,006 (statement of Sen. DeConcini) ("For example, a dissenting class should be assured that no senior class receives more than 100% of the amount of its claims. While that requirement was explicitly included in the House bill, deletion is intended to be one of style and not one of substance."). Also omitted were components related to post-

petition interest and "step-up" when senior creditors are paid in junior securities. *See* Klee, *supra*, at 234-37 (unclear if senior creditors must receive post-petition interest before junior creditors receive anything); 237-38 (unclear if senior creditor may be paid in securities inferior in priority or quality to those issued to junior creditors). *See also* COLLIER ON BANKRUPTCY, *supra*, at ¶ 1129.04[4][b][i].

2. Cases of Literal Compliance with Section 1129(b)(2) That Nonetheless Are Not "Fair and Equitable"

Section 1129(b)(2) not only omitted essential components of the concept of "fair and equitable," it left room for judicial expansion of that concept. As an example, some courts have explored a new area of the fair and equitable rule: a prohibition against the unfair and unreasonable shifting of risk relating to the operations and financial performance of the reorganized debtor. *FSLIC v. D&F Constr., Inc.* (In re *D&F Constr., Inc.*), 865 F.2d 673, 675 (5th Cir. 1989); *Aetna Realty Inv., Inc. v. Monarch Beach Venture, Ltd.* (In re *Monarch Beach Venture, Ltd.*), 166 B.R. 428, 436 (C.D. Cal. 1993); COLLIER ON BANKRUPTCY, *supra*, at ¶ 1129.04[4][b][ii].

These cases demonstrate the fluid and dynamic nature of the "fair and equitable" rule. This open-textured approach is in line with congressional intent and the structure of the Code. Against such a background, it is inconceivable that Section 1129(b)(2)(B)(ii) was intended, without ever saying so, to erase over a century's worth of reorganization practice explicitly recognizing the ability of owners in an insolvent company to contribute new capital and receive in return an ownership interest in the reorganized entity.

III. New Value Concepts Are Part of the Logic and Policy of the "Fair and Equitable" Rule

Throughout the development of the "fair and equitable" principle, owners have always been a source of the fresh

funds often necessary to effect feasible reorganizations. And, as shown below, there is a logical basis and a policy basis for permitting them to make such contributions.

A. *New Value is Logically Identical to Absolute Priority*

Many have labeled the "new value" line of cases as an exception to *Case*'s absolute priority. This is incorrect. Properly applied, new value cases and the absolute priority rule yield the same result.[14] The absolute priority rule simply requires that all of a debtor's value [15] be allocated to senior interests before junior interests can participate on the basis of their pre-petition claims. As stated in *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 318 U.S. 523 (1943), absolute priority rule is met if "each security holder in the order of his priority receives *from that which is available* for the satisfaction of his claim the equitable equivalent of the rights surrendered." *Id.* at 565 (emphasis supplied). *Cf. Kansas City Terminal Ry. Co. v. Central Union Trust Co. of New York*, 271 U.S. 445, 454 (1926) ("Unsecured creditors of insolvent corporations are entitled to the benefit *of the values which remain after lienholders are satisfied*, whether this is present or prospective, for dividends or only for purposes of control.") (emphasis added).[16]

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[14] These relationships can be represented algebraically, and shown to be equivalent. *Owners, Auctions, supra*, at 125-128.

[15] The value available to creditors is often referred to as reorganization value, or the value of the company as a going concern. The bankruptcy court typically determines this value, by application of various means of valuation, such as capitalized earnings, *Group of Institutional Investors*, 318 U.S. at 525-26, or other more modern methods such as discounted present value or stock beta analysis, COLLIER ON BANKRUPTCY, *supra*, ¶ 1129.06.

[16] Against this background, this Court, in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), overstated the scope of the absolute priority rule. This Court said that "the absolute priority rule 'provides that a dissenting class of unsecured creditors must be provided for *in full* before any junior class can receive or retain any property [under a

As a consequence, absolute priority requires that an amount equal to reorganization value be "first appropriated" to payment of dissenting classes of creditors before junior classes may share on account of their pre-petition interests. In short, debt has first call on the value of all corporate assets before equity.

Case's statement of new value, however, imposes the same condition. Under *Case's* new value principles, "where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 122 (1939). Under this test, the money or money's worth contributed must be "reasonably equivalent" to the stockholder's "participation" in the reorganized debtor. In short, the old owners will trade money for an equity interest in the reorganized debtor. If all reorganization value is not first allocated to senior interests, however, then any equity interests -- since they are the residual interests -- will capture some of that value, a result expressly denied by *Case*. As a consequence, any new value plan which complies with *Case* must first allocate all reorganization value, through long-term notes or other property, to senior dissenting claimants before the infusion of new capital.

This, however, is the same condition required by absolute priority. As a consequence, the combination of the two *Case* requirements -- fresh value and reasonable equivalence -- are no more than an alternative statement of the absolute priority rule, and any plan -- such as the one in this case -- which complies with new value principles also will satisfy absolute priority.

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reorganization] plan." *Id.* (emphasis supplied). Not only is this statement contrary to this Court's prior jurisprudence, it also, as shown below in Section III.B., has far-reaching and pernicious implications for bankruptcy policy generally.

B. *New Value Concepts Are Essential to Reorganization Policy*

The ability of owners to contribute new value also promotes reorganization policy. As stated by this Court, "[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources." *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 528 (1984). *See also United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983)("By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. . . . Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap.'"); H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977).

As noted in *Kansas City Terminal*, "additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them." As a consequence, barring or handicapping owners from participating in reorganizations makes no sense. Such a result is unwise, especially in light of studies that show that an increased number of bidders for an object tends to increase the object's final price. *See, e.g.*, Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699, 710-11 (1987); Lance Brannman, J. Douglas Klein & Leonard W. Weiss, *Concentration and Winning Bids in Auctions*, THE ANTITRUST BULLETIN 27, 30-31 (Spring 1984); Charles A. Holt, Jr., *Uncertainty and the Bidding for Incentive Contracts*, 69 AM. ECON. REV. 697 (1979).

If owners may bid for a debtor by proposing a plan, there will then be an increased pool of bidders, potentially leading to increased competition, and increased bids, for the reorganized debtor. Anecdotal evidence in bankruptcy tends to confirm this theory. More bidders mean higher dividends. *See Owners, Auctions*, at 110 n.244 (detailing how competitive bidding in

the cases of Lionel Trains and Financial News Network increased final bids, respectively, from $43 million to $76.8 million, and from $90 million to $146 million).

Unless creditors' participation rights end when they receive their aliquot share of reorganization value, the Bankruptcy Code will also have eroded seriously state laws limiting the liability of investors such as shareholders and limited partners; in short, it will impliedly make investors the guarantors of all pre-petition debt as a condition of continued participation. Not only was such a rule never contemplated by Congress, it would also have the practical effect of eliminating existing investors as contributors of the capital most businesses need to reorganize. The reasons for this elimination are simple. Requiring payment of the full amount of all claims for investors would establish a two-tier pricing system of debtors in bankruptcy: one for existing investors (the full amount of all outstanding claims); and another for new investors (reorganization value). This two-tier pricing would inevitably discriminate against pre-petition owners and investors by making their continued participation more expensive based solely on their status as investors or equity holders. One untoward consequence of such a rule would be the artificial depression of the market in new capital for reorganizing companies. *See Owners, Auctions, supra*, at 106-107.

The last thing that this Court should do is fashion a rule that eliminates or reduces competition for bankruptcy debtors -- and thus reduce creditor dividends -- by excluding or handicapping a group that historically has been ready and willing to invest new funds.

CONCLUSION

New value principles are an historic and logical part of business reorganization practice. Nothing in the language or the structure of the Code changes these practices. The judgment of the Court of Appeals should be affirmed.

Respectfully Submitted,

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